No. 8105

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

RICHARD S. McCREERY, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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INDEX

CITATIONS

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 27–33), which is not reported.

JURISDICTION

This case involves a deficiency in income tax for the calendar year 1930 (R. 33–34). The Commissioner of Internal Revenue determined a deficiency in the sum of $7,162.98 for the taxable year (R. 16–17). The Board redetermined the deficiency in the amount of $1,655.11 (R. 33–34). This appeal, which involves the sum of $5,507.87, is taken from a decision of the Board of Tax Appeals entered on July 27, 1935 (R. 33–34), and is brought to this Court by petition for review filed September 23, 1935 (R. 34–44), pursuant to the provisions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109–110, as amended by Section 603 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 873, and Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169, 286.

QUESTION PRESENTED

The respondent wholly owned and controlled a corporation. At the end of the tax year for the purpose of establishing a deductible loss, the respondent transferred certain stock to the corporation. No cash passed from the corporation to the respondent, but the respondent received a credit on the books of the corporation. Was the transfer sufficient to justify the claimed deduction from the respondent's gross income under Section 23 (e) (2) of the Revenue Act of 1928?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved appear in the Appendix, *infra,* pp. 28–30.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 28–31), and as they appear from the statement of evidence (R. 47–72), are substantially as follows:

The respondent is an individual who designates himself for income tax purposes a "capitalist", whose place of business is in San Francisco, California, and is the president and sole stockholder, except for two qualifying shares, of Burlingame Investment Company, a California corporation, which the respondent caused to be organized and incorporated under the laws of that State in 1924 (R. 28). The company is engaged in buying and selling securities and at one time owned a substantial tract of real estate (R. 28).

From the statement of evidence it appears that the respondent was the sole person in charge of the corporation's active affairs (R. 50), and that he managed the affairs of the corporation entirely and "nobody else had anything to do with it" (R. 58). The respondent supervised the books of the corporation and all entries made therein (R. 52–53).

The respondent always carried an open account with the corporation from its creation and still does so. He was sometimes indebted to the corporation on that account but paid no interest to the corporation on account of his indebtedness, and the corporation paid no interest to the respondent on account of indebtedness "because it was unnecessary" (R. 62). There was no one who could gainsay the respondent if he wanted to buy stock for the company, or lend the company's money, and decisions on these scores were the decisions of the respondent (R. 63). The respondent issued the checks of the Burlingame Investment Company (R. 64).

The Board of Tax Appeals found that on and prior to December 30, 1930, the respondent was the owner of 957 shares of the capital stock of Standard Oil Company of California, 661 shares of Transamerica Corporation, and 160 shares of Caterpillar Tractor Company. Of the said Standard Oil Company shares, owned by the respondent continuously for over two years, 753 had a cost basis to him, for income tax purposes, of $41,046.47, and the remainder, 204 shares, owned less than two years, had a cost basis, for such purposes, of $13,845. Of the Transamerica Corporation stock, owned by the respondent continuously for more than two years, 536 shares have a cost basis to him, for income tax purposes, of $25,070, and 125 shares thereof, owned by him for a period less than two years, have a cost basis of $5,120.05. The 160 shares of Caterpillar Tractor Company were owned by the respondent less than two years, and they have a cost basis to him, for tax purposes, of $6,615 (R. 28–29).

On December 30, 1930, the respondent unqualifiedly sold his said shares of stock of Standard Oil Company, Transamerica Corporation and Caterpillar Tractor Company to Burlingame Investment Company at the closing market quotations shown upon the San Francisco Stock Exchange on that date. Those quotations were as follows (R. 29):

	Per share
Standard Oil Company of California	$44.00
Transamerica Corporation	12.00
Caterpillar Tractor Company	25.75

Immediately upon the sale of the foregoing shares he endorsed the certificates therefor in the name of the Burlingame Investment Company and delivered them either on December 30 or 31, 1930, to the respective transfer agents for the three corporations with instructions to have new certificates issued in the name of Burlingame Investment Company and in due course, that is, within a few days thereafter, the company received the certificates for the stocks which it had purchased, all dated December 31, 1930. Separate individual books of account were kept by the respondent from those of the company. Appropriate book entries were made upon the respondent's individual books of account and upon the books of the company, as of December 31, 1930, showing the sale and the charge therefor, on the one hand, and purchase and liability for payment of the purchase price, on the other, in the following amounts (R. 30):

957 shares Standard Oil Company of California	$42,108.00
661 shares Transamerica Corporation	7,932.00
160 shares Caterpillar Tractor Company	4,160.00

The respondent's personal account upon the books of Burlingame Investment Company, in which all transactions between him and the company were recorded, showed a debit balance against him of $38,000 before the credits of $42,108, $7,932, and $4,160, the purchase price of the three stocks hereinbefore discussed, were credited thereto. After his account received the credits for those amounts on December 31, 1930, and after his said account on that same date had been credited with a dividend of $40,000, it showed a credit balance of $56,200, which balance was carried forward in the account to January 1, 1931. No actual payment by the company was made to the respondent for the purchase price of said stocks. It was at all times possessed of marketable securities, however, several times greater than the amount which it owed (R. 30–31).

The foregoing were the only sales transacted between the respondent and the company during 1930—these were made with income tax deductions in mind. The respondent did, however, sell securities to others during 1930 upon which he sustained and claimed losses in that year (R. 31).

In his individual income tax return for the calendar year 1930 the respondent claimed losses of $12,783.47, $21,290.55, and $2,455, upon the sale of his said shares of Standard Oil Company of California, Transamerica Corporation, and Caterpillar Tractor Company, respectively, which, together with other claimed losses, aggregated $72,684.91 (R. 31).

The Commissioner disallowed the claimed losses on the ground that the alleged sale of the respondent's securities to the corporation was a "colorable" transaction and invalid, and that even if held to be valid it was ineffectual to remove the securities in question from the dominion and control of the respondent, hence no deductible loss resulted. The Board of Tax Appeals held that the claimed losses were deductible under the statute, and accordingly determined that there was no deficiency on this account in the respondent's income tax for the taxable year. It is from this decision that the Commissioner here appeals.

SPECIFICATION OF ERRORS TO BE URGED

The Board of Tax Appeals erred in not finding and holding that the transfer of the securities here in question by the respondent to his wholly owned and controlled corporation was insufficient to justify the deduction of the amount of the claimed losses from the taxpayer's gross income for the calendar year 1930. In connection with and as a part of this specification of errors, the assignments of error set out in the petition for review (R. 34–43) are hereby included herein as fully and completely as if again set forth at this point *in haec verba*. The ensuing argument is intended to apply to each and every of said assignments of error, jointly and severally.

SUMMARY OF ARGUMENT

1. The relationship between the respondent and his wholly owned and controlled corporation was far closer and more intimate than the relationship

ordinarily existing between a stockholder and his corporation. The personal affairs of the respondent were so closely entwined with the business affairs of the corporation as to render it impossible to differentiate between the two personalities in this transaction. In the light of this situation, no real loss could arise out of dealings between the respondent and the corporation. The alleged losses were a mere matter of bookkeeping, and in so far as the respondent is concerned, were never established by an identifiable event, and no loss was finally and definitely realized by the respondent in the instant case.

2. The evidence in this case compels the view that the corporation was completely dominated and used by the respondent in his personal affairs and for that specific purpose. There is no evidence to show that the transaction here in issue was to serve legitimate corporate purposes. Where this close relationship is present, a transaction which has as its purpose the avoidance of income tax offered by the respondent as giving rise to a deductible loss is subject to close and searching scrutiny, and the burden is on the respondent to show that he has in reality sustained a final and complete loss. The respondent's evidence in this case does not sustain the required burden of proof.

3. Section 23 (e) (2) of the Revenue Act of 1928 and its predecessors were never intended to establish a new class of losses, i. e., tax losses. It was

intended to apply to losses resulting from and in the usual course of a taxpayer's business. The evidence in this case falls far short of showing an ordinary business transaction. To the contrary, the evidence does disclose a transfer by the respondent under most unusual circumstances for the purpose of avoiding tax.

ARGUMENT

The relationship between the respondent and the corporation was not the usual relationship ordinarily existing between a stockholder and a corporation. The relationship was far closer and more intimate than such a relationship, and of such an unusual nature as to demand that the identity of the corporation as such be disregarded and that it be treated as the respondent's *alter ego*. The personal affairs of the respondent were so closely entwined with the business affairs of the corporation as to render it impossible to differentiate between the two in the transaction in issue. (a) The respondent owned all the stock of the corporation except two qualifying shares (R. 28). (b) The respondent was president of the corporation (R. 28); the sole person in charge of its active affairs (R. 50); supervised the keeping of the books of account of the corporation and all entries therein (R. 52–53); no one else had anything to do with the corporation (R. 58); the books of the corporation were kept in the respondent's office (R. 60); the respondent issued the checks for the corporation (R. 62), and no one else had authority to sign such checks excepting the respondent (R. 64). The respondent directed the policy of the corporation (R. 63), and from the time of its organization the respondent carried an open account with the Burlingame Investment Company, and while sometimes indebted to the corporation on that account, he paid no interest to the corporation on account of the indebtedness "because it was unnecessary" (R. 62). (c) The corporation did not adopt resolutions authorizing the purchase of the stock from the respondent (R. 63–64). The respondent represented both himself and the corporation in the alleged sale (R. 63). At the time of the transaction here in issue the respondent received no money from the corporation for the stock transferred to it (R. 64), but only a credit entry on the corporate books (R. 55–56). The respondent testified that the stock was transferred to the corporation in order that he might take a deduction from his income tax (R. 65).

The memorandum opinion of the Board of Tax Appeals failed to make specific findings which under the circumstances of this case the Board should have found from the evidence introduced before it. The failure of the Board to find many of the material facts stated in the foregoing paragraph has been assigned as error in the petition for review. For the sake of brevity and to avoid repetition, we refer to the assignments of error set out in the petition for review in the instant case (R. 39–43), and particularly to assignments of error Numbers 2, 3, 4, 5, 6, 7, 8, 9, and 10.

In considering these facts we are concerned with the ultimate conclusion as to whether, when grouped and considered together, they are sufficient to entitle the taxpayer to the deduction which he claims. This is a question of law. *United States* v. *Pugh,* 99 U. S. 265, 269–271; *Winton* v. *Amos,* 255 U. S. 373, 395; *Botany Mills* v. *United States,* 278 U. S. 282; *Ox Fibre Brush Co.* v. *Blair,* 32 F. (2d) 42 (C. C. A. 4th), affirmed *sub nom. Lucas* v. *Ox Fibre Brush Co.,* 281 U. S. 115; *Cohen* v. *Commissioner,* 31 F. (2d) 874, 876 (C. C. A. 4th).

In determining the legal effect of the primary facts, substance rather than form is the determinative element (*United States* v. *Phellis,* 257 U. S. 156); regard is to be had for "the very truth of the matter" (*Eisner* v. *Macomber,* 252 U. S. 189, 211). And in deciding what is the substance of a given transaction the entire plan is to be considered; and this means the plan, not alone as it was conceived, but as it was carried out and completed. One element of the plan is its effect upon the taxpayer; whether his position is changed or left unchanged thereby. *Bourjois, Inc.,* v. *McGowan,* 12 Fed. Supp. 787 (W. D. N. Y.); *Shoenberg* v. *Commissioner,* 77 F. (2d) 446 (C. C. A. 8th).

The Board considered that the fact that the respondent was dealing with a corporation was determinative of the question here presented. The separate entity theory seems to be the basis of the decision. The doctrine "has had in the past a degree of sanctity which was perhaps beyond its deserts. Only the naive still rely too completely on it. * * * It has worked hardship upon taxpayers and has diminished revenue. * * * Today it is a twilight zone of thought and land of shadow. * * *" 5 Paul and Mertens, Law of Federal Income Taxation 833. The theory is governed by the same rules in tax cases as prevail in other cases. The separate identity may be ignored where it otherwise would present an obstacle to the due protection or enforcement of public or private rights. *New Colonial Co.* v. *Helvering,* 292 U. S. 435, 442. It has been stated that the owners of a corporation will not be permitted to use the fiction for subversive purposes. *Farmers' Loan & Trust Co.* v. *Pierson,* 222 N. Y. S. 532. There is "a growing tendency * * * in the courts to look beyond the corporate form to the purposes of it and to the officers who are identified with that purpose." *McCaskill Co.* v. *United States,* 216 U. S. 504, 515. See *Simmons Creek Coal Co.* v. *Doran,* 142 U. S. 417. The language of Lord Mansfield in *Johnson* v. *Smith,* 2 Burn 950, is particularly apropos. He there said (p. 962) that:

> * * * the court would not endure that a *mere form,* or *fiction of law,* introduced for the sake of justice, should work a *wrong,* contrary to the real truth and substance of the thing. * * *

It is always "the act of operation" that we are concerned with. Cf. *Berkey* v. *Third Avenue Railway Co.,* 244 N. Y. 84, 95. A corporation, accordingly, is more nearly a method than a thing. It is hardly more than a name for a useful and usual collection of jural relations, each one of which must in every instance be ascertained, analyzed, and assigned to its appropriate place according to the circumstances of the particular case, having due regard to the purpose to be achieved. *Farmers' Loan & Trust Co.* v. *Pierson, supra* (pp. 543–544).

The Supreme Court has frequently had occasion to disregard the separate juristic personality of the corporation. *United States* v. *Lehigh Valley R. R. Co.,* 220 U. S. 257, 272–274; *Chicago, M. & St. P. Ry.* v. *Minn. Civic Assn.,* 247 U. S. 490, 500–501. (Cf. *Northern Securities Co.* v. *United States,* 193 U. S. 197, 353–354, wherein the acts of the stockholders were treated as the acts of the corporation; and *Mammoth Oil Co.* v. *United States,* 275 U. S. 13, 52, wherein the failure of the owner of the defendant corporation to testify was said to make "strongly against the company." Indeed, the Court seemed to treat the owner and the corporation as one and the same). The separate entity of the corporation has been ignored on several occasions by the Supreme Court in tax cases. *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71; *United States* v.

Johnston, 268 U. S. 220, 227. Of course, the latter cases do not lay down any general rule of law; they were rested upon the *ultimate fact* that in those cases the separate identity did not exist. The facts in this case are as "peculiar", in showing the lack of a separate personality on the part of the corporation, as were the facts in those cases. The latest case in which the Supreme Court has ignored the corporate entity is *Gregory* v. *Helvering,* 293 U. S. 465.

Where the stockholders do not distinguish between the corporate business and their own individual affairs there is no reason why the courts should, at the request of such stockholders, make this distinction. 13 Calif. Law Rev. 235, 236; *Bauernschmidt* v. *Bauernschmidt,* 101 Md. 148, 161–162. This rule has been applied in varying situations on many occasions by the Federal courts. *United States* v. *Milwaukee Refrigerator Transit Co.,* 142 Fed. 247 (E. D. Wis.); *In re Reiger, Kapner & Altmark,* 157 Fed. 609 (S. D. Ohio); *Alpha Portland Cement Co.* v. *United States,* 261 Fed. 339 (C. C. A. 3d); *Majestic Co.* v. *Orpheum Circuit,* 21 F. (2d) 720, 724 (C. C. A. 8th); *Owl Fumigating Corp.* v. *California Cyanide Co.,* 24 F. (2d) 718 (Del.); *Wagner* v. *Lucas* 38 F. (2d) 391 (App. D. C.); *Farkas* v. *Katz,* 54 F. (2d) 1061 (C. C. A. 5th). This rule has been recognized by this Court. *Smith* v. *Moore,* 199 Fed. 689. The rule has been applied by many State courts. *Bank* v. *Trebein,* 59 Ohio St. 316; *Booth* v. *Bunce,* 33 N. Y.

139; *Starr Burying Ground Asso.* v. *North Lane Cemetery Asso.,* 77 Conn. 83; *Gamer Paper Co.* v. *Tuscany,* 264 S. W. 132, 135 (Tex.).

The principle of the cases above discussed requires that this factual situation be realized. The corporation could not have held a higher status in this transaction than that of agent or *alter ego* for the respondent. Cf. *Shoenberg* v. *Commissioner,* 77 F. (2d) 446 (C. C. A. 8th); *Ballwood Co.* v. *Commissioner* (C. C. A. 3d); decided July 16, 1935, not officially reported, but found in 1935 C. C. H., Vol. 3–A, par. 9504. In view of this situation a loss could not arise out of dealings between them in any real sense. Cf. *Wishon-Watson Co.* v. *Commissioner,* 66 F. (2d) 52 (C. C. A. 9th); *Silvertown Motor Co.* v. *United States,* 62 C. Cls. 171; *Rubay Co.* v. *Commissioner,* 9 B. T. A. 133. The claimed loss was at the most a mere matter of bookkeeping. The purchase price was paid in the form of a mere book entry on the corporation's books, and, under all of the facts, the corporation was a mere agent, *alter ego,* or business channel for the respondent, the individual. Hence, the claimed loss was never established by an identifiable event definitely placing legal and equitable title and control beyond respondent. *M. I. Stewart & Co.* v. *Commissioner,* 2 B. T. A. 737.

The evidence in this case, as we have analyzed and discussed it above, supports, we submit, only one conclusion, i. e., that the corporation was completely dominated and used by respondent in his personal affairs and to his personal ends. There is no evidence to show that this transaction was to serve legitimate corporate purposes. The transfer of the stock in the instant case was harmonious with the respondent's practice in the use of the corporation for personal purposes. Had the respondent sold the stock in the open market he would no doubt have sustained deductible losses for the reason that the losses would have been established by an identifiable event placing the legal and equitable title to and control over the stock definitely beyond the respondent. This the respondent did not do. He merely transferred the stock to the corporation "at the market" and set up a credit to himself on the books to reflect the sales price. No corporate purpose was served thereby, and thereafter the control of the stock at the least remained just as definitely and absolutely in the respondent as it had theretofore been. The sole benefit of the transaction could have been only to the respondent: an attempt to establish a deductible loss.

A transaction between a stockholder and his corporation is always closely scrutinized. *Glenwood Hotel Co.* v. *Commissioner,* 5 B. T. A. 985; *John M. Burdine Realty Co.* v. *Commissioner,* 20 B. T. A. 54. When such a relationship exists it is incumbent upon the taxpayer "to establish not only an actual sale, but its good faith as well." *Wishon-Watson Co.* v. *Commissioner, supra* (p. 55). We submit that the taxpayer's proof fails to meet that test. There has not been shown the reality (*United States* v. *Flannery,* 268 U. S. 98), finality, and completeness (*United States* v. *White Dental Co.,* 274 U. S. 398) of the loss. The *prima facie* presumption in favor of the Commissioner's determination certainly requires evidence establishing those things with certainty; the evidence in this case is clearly insufficient to overcome the presumption.

It is extremely doubtful under the facts of this case that even technical legal title to the stock ever passed to the corporation. The relationship between the respondent and the corporation was such as to disqualify him from acting for it in the transaction. Certainly, the burden of affirmatively providing good faith rested upon the taxpayer in this case. *Wishon-Watson Co.* v. *Commissioner, supra.*

Section 23 (e) (2) of the Revenue Act of 1928 and its predecessors were never intended to establish a new class of losses, i. e., tax losses. Each of those statutes was intended to apply to losses resulting from the usual course of a taxpayer's business. Such reasoning was applied in construing the tax-free reorganization provisions of the Revenue Acts. *Gregory* v. *Helvering, supra* (293 U. S. 465). The Court there said (p. 470):

> The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive

> the statutory provision in question of all serious purpose.

This rule was applied in the case of sales between stockholders and their corporation. *Commissioner* v. *Riggs,* 78 F. (2d) 1004 (C. C. A. 3d). The court there said (p. 1005):

> The decisive thing is whether or not what has been done is "the thing which the statute intended." The taxpayer must bring himself within the intent of the statute upon which he relies, and in the case at bar the taxpayers did not do so. They did not undergo business losses such as are actually contemplated in the statute, but conceived the losses in paper transactions in order to escape the burden of their tax liability.

The Revenue Acts contemplate the deduction of losses arising out of sales entered into "for reasons germane to the conduct of the venture in hand." To dodge taxes can hardly be said to be one of the transactions contemplated by the term "sale." Cf. *Gregory* v. *Helvering, supra.*[1] In that case the court refused to accept a corporate reorganization as tax free although there had been a ritualistic compliance with Section 112 (i) (1) (A) of the Revenue Act of 1928. The ground for the court's decision was that the sole purpose was to escape taxation and the reorganization served no legitimate business purpose. The law, in allowing de-

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[1] See also the opinion of the Circuit Court of Appeals for the Second Circuit, 69 F. (2d) 809, 811.

ductions, "certainly contemplates that from legitimate transactions legitimate results shall be deduced." *Silvertown Motor Co.* v. *United States,* 62 C. Cls. 171, 178.[2]

The test of germaneness, for the first time clearly enunciated in the *Gregory* case and clearly and definitely applied to a claimed deduction of a loss arising out of an alleged sale in the *Riggs* case, is supported by the provisions of the revenue acts. The income-tax provisions of the various revenue acts have reflected a great difference in the manner of treating gains and losses. The prime objective of all income-tax acts is, of course, to tax incomes. To grant deductions is not an object of such acts, although such deductions are allowed in a few instances, and only as a matter of legislative grace. *New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440. A taxpayer is not entitled to a deduction from gross income as a matter of right. *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364. Income includes "income * * * of whatever kind and in whatever form paid * * * derived from any source what-

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[2] The Supreme Court has declared that, in construing a statute, it is not always confined to a literal reading, and may consider its object and purpose and the things with which it is dealing, so as to effectuate, rather than destroy the spirit and force of the law. *American Tobacco Co.* v. *Werckmeister*, 207 U. S. 284, 293. The intention of the legislative body will prevail even against the letter of the statute. *Fleischmann Co.* v. *United States*, 270 U. S. 349, 360; *Hawaii* v. *Mankichi*, 190 U. S. 197, 212; *Petri* v. *Commercial Bank*, 142 U. S. 644, 650.

ever." Section 22 (a) of the Revenue Act of 1928.[3] Thus Congress has included within the definition of income, and hence has reached for taxation, subject to such deductions as it may allow, "gains or profits and income derived from any source whatever." Section 22 (a) of the Revenue Act of 1928. This provision is sufficiently broad to cover all gains, whether from cash transactions or not. "The intent of Congress was to levy the tax * * * upon all sorts of income." See *Choteau* v. *Burnet*, 283 U. S. 691, 694.[4] Losses present an entirely different situation. It was not necessary that Congress should provide for the deduction of any losses whatever. There is this distinction between gains and losses in the very provisions of the revenue acts: Profits, gains, and income of all types are taxable and the idea of germaneness is not included within those provisions; however, when we come to the provisions relating to deductions and tax-

[3] The same language is contained in prior and subsequent revenue acts. For example, Section 22 (a) of the Revenue Act of 1932, c. 209, 47 Stat. 169; Section 22 (a) of the Revenue Act of 1934, c. 277, 48 Stat. 680 (U. S. C., Title 26, Sec. 22); Section 213 (a) of the Revenue Act of 1926, c. 27, 44 Stat. 9; Section 213 (a) of the Revenue Act of 1924, c. 234, 43 Stat. 253; Section 213 (a) of the Revenue Act of 1921, c. 136, 42 Stat. 227; Section 213 (a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057; Section 2 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756.

[4] "* * * a reference to * * * the act passed following the sixteenth amendment will disclose a more embracing phraseology than mere 'net income'." *Baldwin Locomotive Works* v. *McCoach*, 215 Fed. 967, 969 (E. D. Pa.).

free transactions we find that throughout those provisions there runs this thread of germaneness, as enunciated by the court in the *Gregory* case.

In this connection it is interesting to trace the history of the present loss provisions. Under the Corporation Excise Tax Act of 1909 corporations were allowed to deduct "all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties * * * [and] all losses actually sustained within the year and not compensated by insurance or otherwise." Section 38, Second. This language was contained in the income tax provisions of the Revenue Act of 1913 (except that the business expenses did not have to be paid out of income). Section II G (b). In addition, the 1913 Act permitted individuals to deduct "losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise." Section II B, Fourth. The only change made in the 1916 Act and in the 1917 Act in the right to corporations to deduct losses was a provision that such losses must be charged off within the year. As to individuals, these last-named acts added losses from "other casualty, and from theft", and from "transactions entered into for profit but not connected with his business or trade * * * to an amount not exceeding the profits arising therefrom." Section 5 (a). The

1918 Act allowed the same deductions as the 1916 and 1917 Acts and removed the restriction with respect to the limited deductibility of losses arising from transactions entered into for profit but not connected with the taxpayer's trade or business. In other words, the 1918 Act permitted the deduction of all losses sustained during the taxable year "if incurred in any transaction entered into for profit." Section 214 (a) (5) of the Revenue Act of 1918. It is obvious that the provisions of the later revenue acts relating to deductions originated with Section 38, Second, of the Corporation Excise Tax Act of 1909. Certainly the provision of the 1913 Act relating to deductible losses of individual taxpayers was no broader than the provision relating to deductible losses of corporations. Sections II B (Fourth) and II G (b) (Fourth). The provision allowing the deduction of a loss "in any transaction entered into for profit" is contrasted with the provision allowing the deduction of losses incurred "in trade or business." The terms "trade or business" comprehend all activities for gain, profit, or livelihood entered into with sufficient frequency or occupying such portion of one's time or attention as to constitute a vocation, an occupation, or a profession (Mim. 3283, IV–I Cumulative Bulletin 14), whereas the provision as to any transaction entered into for gain or profit relates to isolated business transactions. Thus the history of the provisions relating to deductible losses supports the theory that the losses must be legitimate business losses; they must arise out of transactions germane to the conduct of the venture in hand; hence, the claimed losses must be business realities.

The distinction between a gain and a loss is further illustrated by the fact that income may be accrued, and when so accrued, is taxable. Sections 41, 42, and 43 of the Revenue Act of 1928.[5] See *United States* v. *Anderson,* 269 U. S. 422. However, there is no provision in the acts for accruing losses. On the contrary, the provisions relating thereto require the loss to be actually sustained in order to be deductible. *United States* v. *Flannery, supra.* Cf. *Eckert* v. *Burnet,* 283 U. S. 140. Another example is to be found in the fact that while gains from illegal transactions have been held to be taxable under all revenue acts subsequent to the one of 1913, losses on such transactions are not deductible. Klein, Federal Income Taxation, p. 503; Article 41 of Regulations 45. See S. M. 2680, III–2 Cumulative Bulletin 110; S. M. 2680A, IV–1 Cumulative Bulletin 147; L. O. 1092, I–1 Cumulative Bulletin 270; I. T. 1854 and 1865, II–2 Cumulative Bulletin 125. The correctness of the theory of the *Gregory* and *Riggs* cases, namely, that the claimed loss to be deductible must arise out of a

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[5] For like provisions in earlier acts see Sections 212 (b), 213 (a), and 200 (d) of the Revenue Acts of 1924, 1921, and 1918.

genuine business transaction, is further shown by an analysis of the provisions relating to deductions. Referring to these provisions, as found in the Revenue Act of 1928, Section 23 (a) allows as a deduction "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any *trade or business*" (italics supplied), as well as rentals or other payments for the use or possession, "for purposes of the *trade or business*" (italics supplied), of property now used by the taxpayer. Again Section 23 (e) (1) deals with "Losses sustained * * *, if incurred in *trade or business*" (italics supplied); and Section 23 (e) (2) permits the deduction of losses *sustained* "if incurred in any transaction entered into for profit." In other words, isolated ventures are here recognized, where entered into for profit. The key word in this provision is "profit", which definitely relates the statute to isolated *business* ventures.[6] Section 23 (e) (3) relates to losses *sustained* of property not connected with a trade or business by an act of God or by theft—if not compensated for. In other words, the loss must

[6] Profit is "the gain resulting from the employment of capital—the excess of receipts over expenditures." *Fechteler* v. *Palm Bros. & Co.*, 133 Fed. 462, 469 (C. C. A. 6th). It is "the advantage or gain resulting from the investment of capital, or the acquisition of money beyond the amount expended; a pecuniary gain." *Goldsborough* v. *Burnet*, 46 F. (2d) 432, 433 (C. C. A. 4th). The Treasury rulings have been consistent with these definitions.

be actual, not synthetic. Section 23 (j) refers to debts *ascertained* to be worthless. Section 23 (k) and (l) applies only to trades or businesses. The normal basis for determining the amount of gain or loss from a sale is the cost. Section 113 (a). The entire amount of such gain or loss is to be recognized. Section 112 (a). "* * * the loss shall be the excess of such basis over the amount realized." Section 111 (a). It is obvious from the very terms of these pertinent statutes that Congress was allowing deductions for losses growing out of the usual course of a taxpayer's business or commercial endeavors. Such endeavors must be the source of the claimed loss. Certainly, we submit, it cannot be said that Congress enacted these provisions for deductions merely for the purpose of enabling taxpayers to evade the taxes imposed by other provisions of the Act.[7] "The mind rebels

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[7] In *Holy Trinity Church* v. *United States*, 143 U. S. 457, the Court said (p. 459): "It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers. This has been often asserted, and the reports are full of cases illustrating its application. This is not the substitution of the will of the judge for that of the legislator, for frequently words of general meaning are used in a statute, words broad enough to include an act in question, and yet a consideration of the whole legislation, or of the circumstances surrounding its enactment, or of the absurd results which follow from giving such broad meaning to the words, makes it unreasonable to believe that the legislator intended to include the particular act. As said in Plowden, 205: 'From which cases, it appears that the sages

against the notion that Congress * * * was willing to foster an opportunity for juggling so facile and so obvious." See *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 330.

We are not unmindful that the decision of this Court in *Commissioner* v. *Eldridge,* 79 F. (2d) 629, was on facts hardly distinguishable from those in the instant case, and that the argument advanced on behalf of the Commissioner in the instant case is in all respects identical with that advanced on behalf of the Commissioner in the *Eldridge* case. In the *Eldridge* case the Board of Tax Appeals made no finding on the evidence tending to prove in that case a peculiar intertwining of the personal affairs of the taxpayer with the affairs of the corporation. In that case the failure of the Board to make such findings was not assigned as error and hence that evidence was not before the Court and the Court affirmed the decision of the Board because there was substantial evidence to support such findings as were made by the Board. In the

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of the law heretofore have construed statutes quite contrary to the letter in some appearance, and those statutes which comprehend all things in the letter they have expounded to extend to but some things, and those which generally prohibit all people from doing such an act they have interpreted to permit some people to do it, and those which include every person in the letter, they have adjudged to reach to some persons only, which expositions have always been founded upon the intent of the legislature, which they have collected sometimes by considering the cause and necessity of making the act, sometimes by comparing one part of the act with another, and sometimes by foreign circumstances.' "

instant case the failure of the Board to make findings on the evidence before it which tended to prove a peculiar intertwining of the personal affairs of the respondent with the affairs of the corporation, and that they were in effect a single identity for all practical purposes, to be treated as such, has been assigned as error. As we have hereinbefore pointed out, for this reason we submit that the decision in the *Eldridge* case is not determinative here where the record properly presents the issue and that issue is to be determined by a full review warranted by the assignments of error, which was not the situation in the *Eldridge* case.

CONCLUSION

In conclusion we respectfully submit that the decision of the Board of Tax Appeals is erroneous and should be reserved.

Robert H. Jackson,
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April 1936.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax equal to the sum of the following:

* * * * *

SEC. 12. SURTAX ON INDIVIDUALS.

(a) *Rates of surtax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as follows:

* * * * *

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

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(e) *Losses by individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

*　　*　　*　　*　　*

(2) If incurred in any transaction entered into for profit, though not connected with the trade or business; * * *.

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SEC. 118. LOSS ON SALE OF STOCK OR SECURITIES.

In the case of any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) or has entered into a contract or option to acquire substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, no deduction for the loss shall be allowed under section 23 (e) (2) of this title; nor shall such deduction be allowed under section 23 (f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business. If such acquisition or the contract or option to acquire is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

> ART. 171. *Losses.*— * * *
>
> Losses must usually be evidenced by closed and completed transactions. * * *
>
> ART. 174. *Shrinkage in value of stocks.*— A person possessing stock of a corporation cannot deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. If stock of a corporation becomes worthless, its cost or other basis determined under section 113 may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made, as in the case of bad debts. * * *

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